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May 12, 2008

AGENDA ITEM 7a

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: External High Yield Manager Annual Review

II. PROGRAM: External High Yield Fixed Income

III. RECOMMENDATION: Renew the contracts for two of CalPERS' external high yield managers for a period of one year. The two managers are:

- Nomura Asset Management Inc.
- Pacific Investment Management Company

IV. ANALYSIS:

Background

The CalPERS' external high yield program (Program) began with the funding of managers in February 2002 under annual contracts. All managers have been with CalPERS since the inception of the Program. For a detailed description of each manager's style, see Appendix A. The objective of the Program is to provide diversification and return enhancement within the CalPERS fixed income investment allocation.

Staff has lost two managers since the original RFP and is currently conducting a new RFP. Staff's current plan is to present the new managers at the September 2008 Investment Committee Meeting.

Recommendation

Staff is recommending renewal of two external high yield manager contracts for a period of one year. Wilshire's recommendation for these managers can be found in attachment 1. Wilshire's disclosure letter is attachment 2.

Market Environment

The 12 month reporting period (March 31st, 2007 to March 31st, 2008) experienced two distinctly different market environments. The first 3 months (March 31 to June 30) of the period started out as a relatively benign period for the high yield market. However, the tone of the high yield market turned negative in July 2007 lead by the housing market downturn and an oversupply of leveraged loans. Over the 12 month period, the high yield market returned -3.40%.

Despite these negative returns, high yield market credit metrics remained relatively strong. The JP Morgan 12 month default rate was 0.71% over the reporting period, which is lower than the 25 year average rolling 12 month default rate of 4.13%.

Manager Performance

The strategic objective of CalPERS' high yield fixed income program is to provide diversification and return enhancement to CalPERS' fixed income portfolio. The objective of the external managers is to outperform CalPERS' Lehman Custom High Yield Cash Pay Index (benchmark) net of all management fees.

Due to diminished available risk premiums and excess return potential, staff chose to enter the 12 month period with a slight underweight to high yield within the US Dollar Denominated Fixed Income portfolio. As of March 31st, 2008, total assets managed by Nomura and PIMCO were approximately $416 million dollars.

The two managers, as a whole, underperformed the benchmark by 133 basis points during the 12 month period. (See Figure 1 for details)

Annualized return for both managers since inception (March 2002) was 7.95% versus 7.73% for the benchmark. The information ratio since inception for the Program has been 0.10, while the information ratio for the 12 month period was -0.35.

FigureTable 1. Managers Aggregate

Source: State Street/Highland

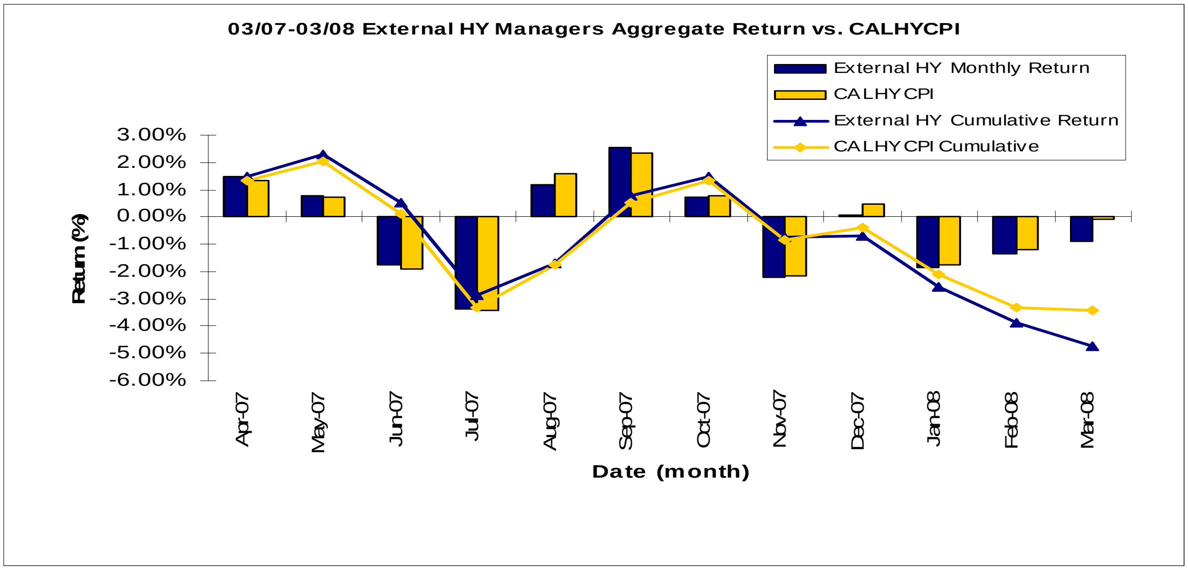


Table 1:Manager Returns and Assets for the Period ending 03/31/2008

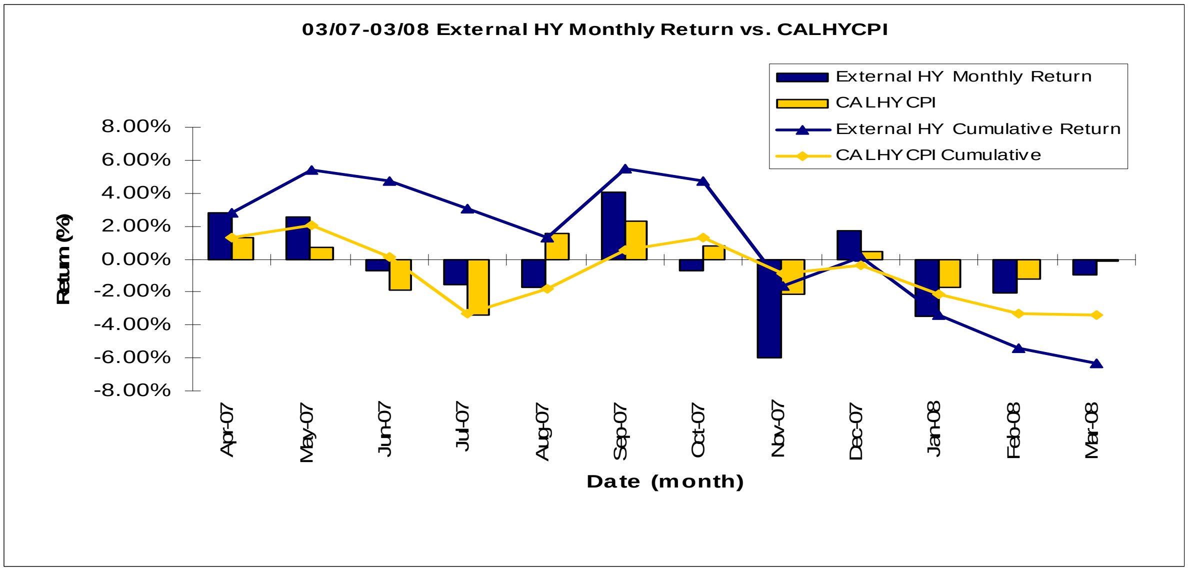
Source: State Street

Active Strategy	1 Year Portfolio Returns	1 Year Benchmark Returns	1 Year Excess Return	Excess Returns Since Inception	Assets 3/31/2008 (in millions)	Percent of External Program
Nomura	-6.66%	-3.40%	-3.26%	-0.24%	$204	18%
PIMCO	-2.79%	-3.40%	0.61%	0.31%	$212	19%
Total	**-4.73%**	**-3.40%**	**-1.33%**	**0.22%**	**$416**	**37%**

Individual Managers Performance and Evaluation

Manager Returns and Assets for the Period ending 03/31/2008

Source: State Street

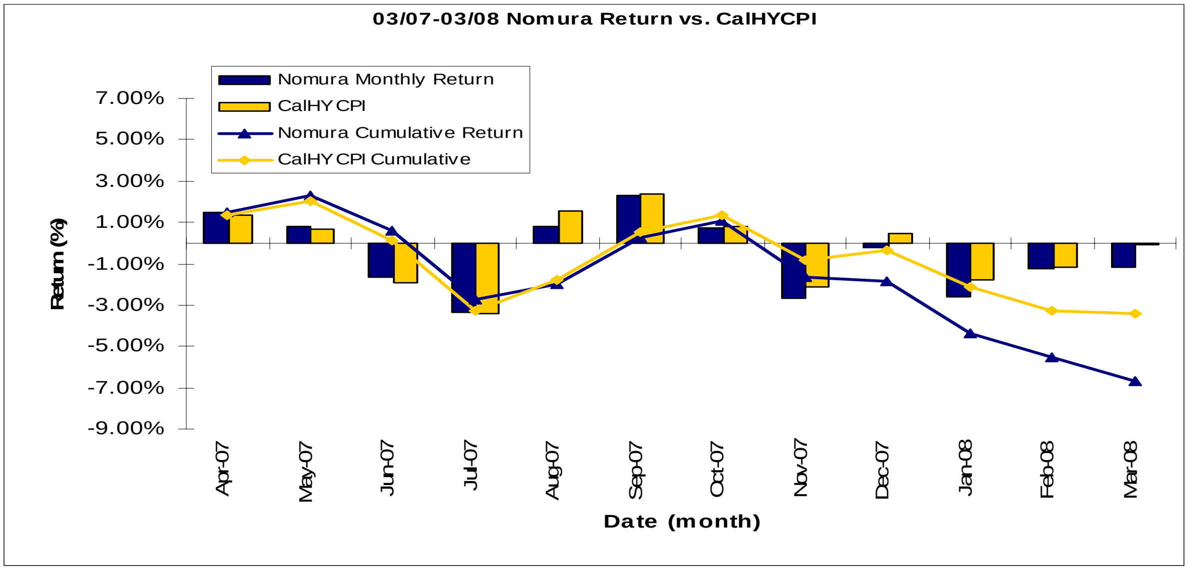


Nomura:

Over the 12 month period, Nomura's return was -6.66% versus the Benchmark return of -3.40% which is -326 basis points in excess return. (See Figure 5 for details) Nomura's higher beta management style was penalized over the 12 month period. Staff has reviewed Nomura and believes that Nomura's style will be rewarded once market conditions become more favorable for the high yield asset class. Staff will continue to monitor this manager's progress and will report back to the Investment Committee as necessary. The manager's annualized performance since inception was 7.81% whereas the benchmark annualized return was 8.05%. The information ratio since inception for Nomura has been -0.09, while the information ratio for the 12 month period was -2.03. As of March 31st, 2008, Nomura had $204 million under management for CalPERS.

Figure 5. Nomura Asset Management 12 Month Returns vs. Benchmark

Source: State Street

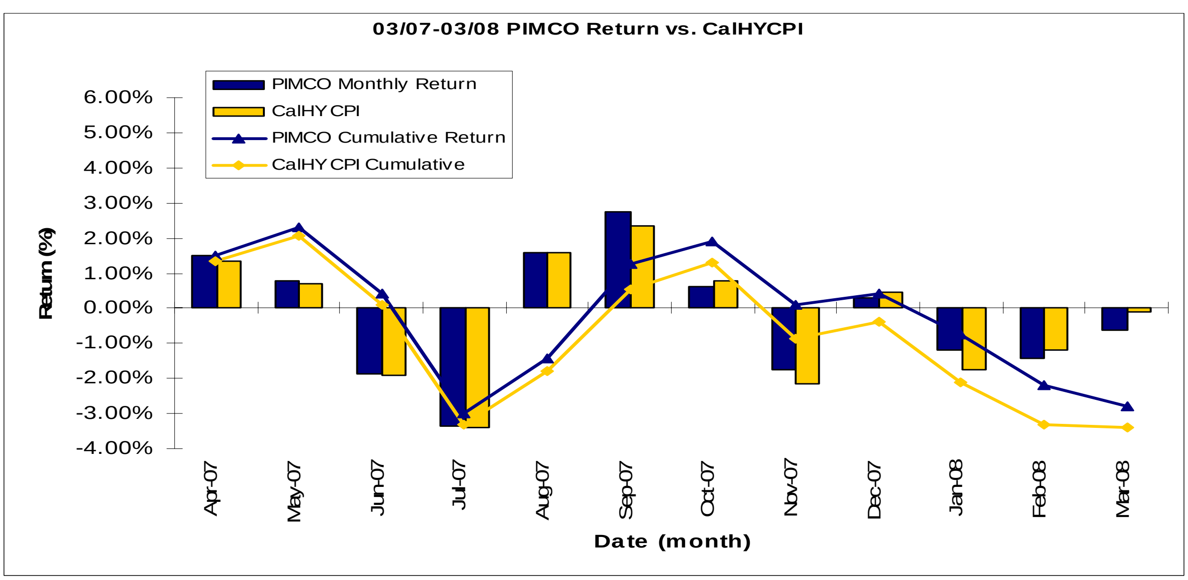


PIMCO:

Over the 12 month period, PIMCO's return was -2.79% versus the Benchmark return of -3.40% which produced 61 basis points in excess return (See Figure 6 for details). The manager's annualized performance since inception was 8.04%, whereas the benchmark annualized return was 7.72%. The information ratio since inception for PIMCO has been 0.15, while the information ratio for the 12 month period was 0.58. As of March 31st, 2008 PIMCO had $212 million under management for CalPERS.

Figure 6. PIMCO Performance vs. Benchmark

Source: State Street



V. STRATEGIC PLAN:

External investment manager performance is monitored by staff and reported to the Investment Committee per CalPERS' Strategic Plan, Goal VIII: Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

VI. RESULTS/COSTS:

The purpose of this item is to keep the Investment Committee informed of staff's efforts to ensure that the high yield fixed income external manager program is performing in line with expectations.

Todd L. Smith
Portfolio Manager

Kevin Winter
Senior Portfolio Manager

Curtis D. Ishii
Senior Investment Officer

Anne Stausboll
Interim Chief Investment Officer

Appendix A

Nomura:

Nomura’s investment philosophy is based on a deliberate bottom-up investment approach designed to invest in improving credits with the goal of achieving a coupon and small capital gain, while simultaneously avoiding credit losses. In general, the firm’s process revolves around identifying and investing in what it believes to be “strong horse” companies, or those companies that exhibit the potential to de-leverage their balance sheets, generate stable cash flow, and are credit upgrade candidates.

Nomura’s investment decision-making process is a collaborative effort with ideas generated by the whole team. By monitoring developments in their assigned industries and trading levels of securities in those industries, Nomura’s investment team successfully remains abreast of the market.

PIMCO:

PIMCO's investment philosophy embodies five key principals: 1) focus on higher quality below investment grade credits; 2) a total return approach and preservation of capital; 3) diversification broadly across issuers and industries; 4) use of extensive credit research to identify improving credits; and 5) use of PIMCO’s expertise in mortgages and other sectors to identify non-traditional high yield opportunities.

PIMCO believes that analyzing secular economic and political influences is fundamental to sound portfolio decisions. The macroeconomic analysis is combined with a fundamental, bottom-up style of selecting high yield credits. Top-down analysis is used primarily to determine average quality and secondarily duration and yield curve exposures in high yield portfolios. However, it is fundamental, bottom-up credit research that is the primary method of selecting securities and adding value in PIMCO’s high yield portfolios.